Issue no. 196
May 2014

airberlin: an airline in search of a strategy

WHEN a company mentions the words "going concern" more than once in its annual report, it usually a little concerning. The fact that airberlin, Germany's second largest airline, felt the need to use the phrase a dozen times in its 2013 report (twice as many as in the previous year), without even once mentioning its aircraft order backlog, may perhaps suggest that it has become necessary for the directors to convince themselves and the auditors of the fact.

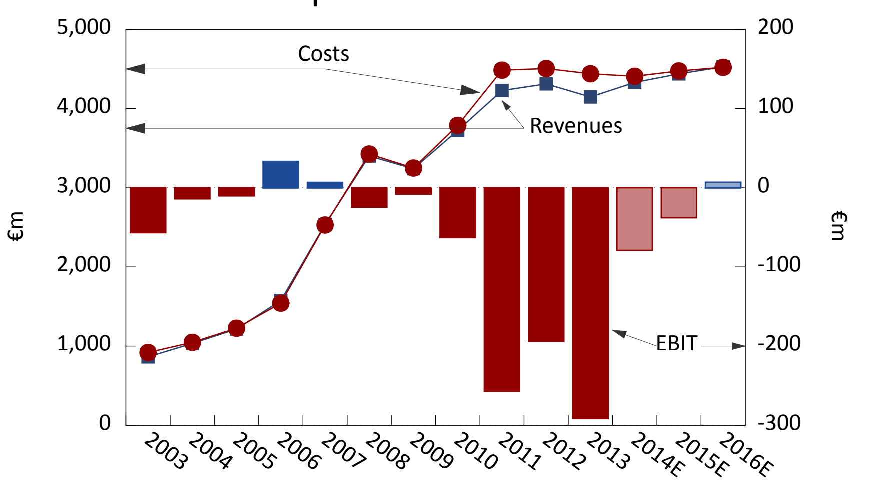
The company's annual report does not make pleasant reading. In the year to end December capacity fell by 5% as planned but passenger numbers declined by 5.5% to 32m. Revenues dropped by nearly 4% (with a 5% decline in ticket sales) to €4.2bn while published operating results slumped to a loss of €232m, against a profit of €70m in the previous year. The latest cost saving programme (under the soubriquet "Turbine") is said to have generated over €200m in cost savings, but the underlying EBITDAR margin slipped 2 basis points to an unsustainable 9% – the lowest level since 2003.

Moreover, the €232m loss is stated after non-recurring exceptional income of €60m, relating to profits on asset sales and indemnities (in the previous year the company had recorded a profit on the sale of 70% of its frequent flyer plan to Etihad).

Reported net losses came in at €316m compared with a reported €7m profit in 2012. On the balance sheet the company reported negative equity of €186m and a cash position of only €223m, a paltry 5% of annual revenues.

The results for the first quarter of 2014 do not make much better reading – although to be fair this is the weakest period of the year and this year the period did not include Easter. The number of passengers fell by 1% but capacity had grown by 4%; the load factor fell by 4 points to 82%. Published operating losses improved slightly to €182m, which prompted the company again to state that its *Turbine* programme is working (the aim is to generate a cumulative reduction in running costs of €400m by the end of 2014). Unit costs fell by 8% but yields were down 4% and unit revenues by 8% giving total revenues down by 4% (and ticket sales were down 5%). Net losses swung in at €210m compared with €196m in the prior year period. As a result the negative equity on the balance sheet worsened to just short of €400m.

Air Berlin plc Financial Performance



Source: Company reports, AS analysis

This issue includes

Published by Aviation Strategy Ltd

Aviation Strategy

ISSN 2041-4021 (Online)

This newsletter is published ten times a year by Aviation Strategy Limited Jan/Feb and Jul/Aug usually appear as combined issues. Our editorial policy is to analyse and cover contemporary aviation issues and airline strategies in a clear, original and objective manner. Aviation Strategy does not shy away from critical analysis, and takes a global perspective – with balanced coverage of the European, American and Asian markets.

Publisher:

Keith McMullan
James Halstead

Editorial Team

Keith McMullan
kgm@aviationstrategy.aero

James Halstead
jch@aviationstrategy.aero

Heini Nuutinen
hn@aviationstrategy.aero

Nick Moreno
nm@aviationstrategy.aero

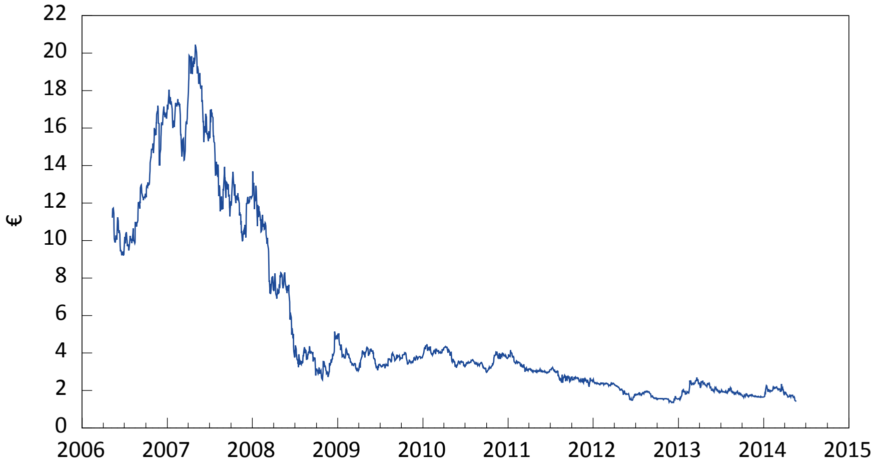
Tel: +44(0)207-490-4453
Fax: +44(0)207-504-8298

Subscriptions:

info@aviationstrategy.aero

Aviation Strategy Ltd
Registered No: 8511732 (England)
Registered Office:
137-149 Goswell Rd
London EC1V 7ET
VAT No: GB 162 7100 38
ISSN 2041-4021 (Online)

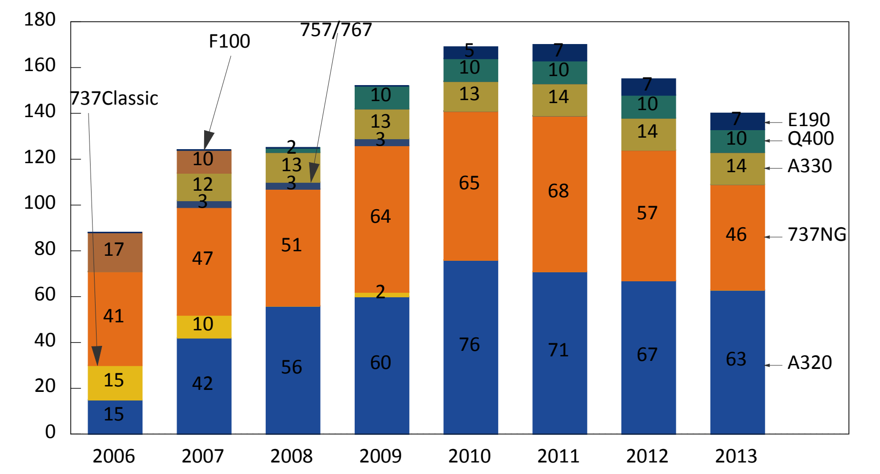
Air Berlin plc Share Price



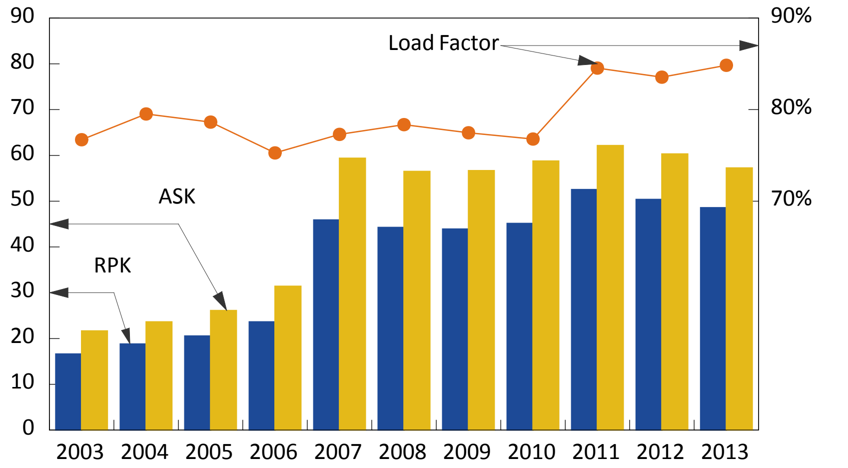
At the same time as the publication of the annual results (delayed a month as the company no doubt debated the question of whether it was a "going concern") airberlin announced an emergency recapitalisation. Major shareholder Etihad had agreed to inject a further €300m in the form of a perpetual payment-in-kind convertible bond and extend its existing shareholder loan of $255m (of which less than $100m drawn, and due to expire in 2016) by five years. In addition, the company announced the issuance of a new €250m senior bond (€100m of which is to redeem existing debt). Because of the peculiarities of accounting standards, the perpetual bond can be treated as equity on the balance sheet and thus can be seen to offset the existing negative equity. The conversion terms on the bond (at the equivalent of €1.79 a share) would potentially give Etihad a 70% stake in the company – well above the 49% limit for non-EU nationals.

The company recognises that the *Turbine* programme is not going far enough and has created a new position on the management board of a Chief Restructuring Officer to pursue a new restructuring programme, while stating that Etihad would *"further support airberlin and help the business restructure and return to*

airberlin Group Fleet



airberlin Capacity, demand and load factors



sustainable profitability". Etihad has apparently placed two executives in the business (James Hogan, CEO of Etihad and his CFO already sit as non-executive directors on the board) and hired a management consultancy to "re-engineer airberlin".

Hogan is nothing if not consistent – exactly the same strategy is being applied to similar crises at Jet Airways, Etihad's Indian investment – see page 12.

Re-engineering necessary?

airberlin *should* be in a relatively strong position. It is the second largest carrier in Germany (the largest outbound tourist market in the world) and with 32m passengers carried a year the seventh largest airline in Europe. It is the largest operator in Berlin, Düsseldorf and Palma de Mallorca. It has seemed to have had a relatively cosy duopolistic relationship in its key German speaking markets (Germany, Austria and Switzerland) with Lufthansa – which has been relatively happy to have airberlin help keep out the European LCCs. Up to now however, its strategy has appeared confused.

airberlin is one of the few former charter carriers to convert to scheduled operations. When it came to the markets in its IPO in 2006 it sold itself on the basis of being a low cost carrier (that being the flavour of the month). At the time half of its services were still on charter operations from German regions to the short haul leisure destinations in the Mediterranean. It had built a hub operation in Palma to funnel demand from the disparate German regions onward to Spanish leisure destinations – although short haul transfer hubs in Europe are somewhat questionable – and had a burgeoning domestic and intra-European City Shuttle service.

In quick succession it acquired dba, to become the second largest German scheduled carrier and a contender to Lufthansa, and Düsseldorf-based LTU, a charter carrier with an extensive long-haul operation (both acquired airlines were financiallly very weak), hoping to become a grown-up intercontinental player and described itself as a hybrid scheduled and leisure carrier. By 2008 it had grown to carry 30m passengers a year and had plans to continue to grow strongly.

Since then growth has faltered. The number of aircraft in the fleet reached a peak in 2010 at 169 units and has since fallen to 140. The number of passengers carried peaked in 2011 at 35m 11% higher than in 2013. Total capacity in ASK in 2013 was 1% higher than five years ago, although it has been able to improve load factors by 6.5 points over the period and de-

airberlin Balance Sheet Analysis

€m	2013	Q1 2014	Net bond issues	Proforma
Equity	(186)	(399)	300	(99)
Intangible Assets	416	414		414
Adj shareholders' funds	(602)	(813)		(513)
Long term debt	784	860	150	1,010
Short term debt	235	214		214
Cash	223	273	450	723
Cash % revenues	*5.4%*	*6.6%*		*17.4%*
Net Debt	796	801		501
Debt/CE	1.22	1.59		1.25
Debt/Adj CE	2.44	4.12		1.72
Capitalised rentals	4,634	4,101		4,101
Debt†/CE	1.03	1.08		1.02
Debt†/Adj CE	1.12	1.19		1.11

Source: Company reports, Aviation Strategy analysis. Note: CE=debt + equity
†Includes capitalised leases.

mand in RPK is up by 10% compared with 2008 – a compound average annual growth rate of 1.8%.

The company seems to have been trying to reinvent itself as a full service carrier at “affordable” fares. In July 2010 it announced plans to join the **one**world alliance (this came into effect in March 2012 after the usual eighteen month gestation period). In December 2011, meanwhile, it struck a strategic partnership with Etihad, after the super-connector increased its equity stake to 29%, and formed what appears now to be the cornerstone of what has been called Etihad’s *Egocentric Equity Alliance*. As part of this arrangement, airberlin and Etihad have been generating closer co-operation – with wide-ranging codeshare agreements (including some with Etihad’s other codeshare partners, Air France and KLM); pooling of the airberlin 787 orders with those of the Gulf carrier; and reciprocal pilot exchange.

When the company came to the markets in 2006 it had equity on its balance sheet of €197m and managed to publish a net profit for 2006 of €50m up from a prior year loss of €116m. This was also the last year it made an underlying operating profit. Since then unit costs have grown by 58% (or an annual average of 6.7%) and unit revenues by 44% (or an annual average of 5.3%). Over the period airberlin has lost a total of €1.1bn and has tapped shareholders for €480m (excluding the recently announced perpetual bond).

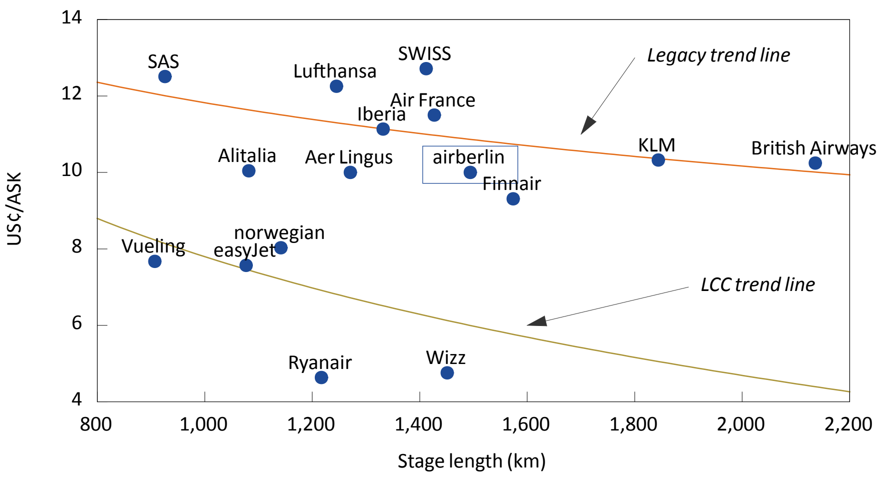
The emergency recapitalisation probably does not go far enough. The balance sheet includes intangible assets of some €415m – a large part of which refer to the slots at airports capitalised on the acquisition of dba and LTU. Excluding these from the net assets give negative shareholders’ funds of €813m at the end of March. On-balance sheet debt totals €1.1bn (a minority of which relates directly to aircraft funding), but a capitalisation of operating leases could add an extra €4.1bn to liabilities.

Against this there is only €273m in cash and equivalents. The cash from the Etihad convertible is due in three tranches through the current year. On a proforma basis (and treating it as equity) shareholders’ funds would fall to a negative €513m against net debt including capitalised leases of €4.4bn – but at least it will provide gross cash equivalent to two months’ revenues.

airberlin in its current structure is possibly incapable of being profitable. As it moves towards trying to be a full service network carrier and as it moves closer to Etihad, as seems inevitable, the charter operations and leisure oriented European routes might become increasingly non-strategic. In particular the intra-European leisure transit hub in Palma, despite previous protestations by the company, is probably in reality badly loss-making. There have already been some suggestions that the group may consider separating into two – a scheduled operation based in Germany attractive to Etihad, and a charter business.

This in turn however may not go far enough. A prime problem is that whereas it has a relatively competitive cost base in comparison with Lufthansa as a group, Lufthansa has been pushing its non-hub routes into relatively low cost germanwings (narrowing the unit cost differential on like-for-like basis). It too suffers from the same problems as Lufthansa in the German market – the country’s federal structure provides a disseminated population distribution; and although its hub in Düsseldorf may be in the relatively densely populated North Rhine Westphalia, the airport (the third largest in Germany after Frankfurt and Munich) is heavily congested with limited possibility for expansion. At the same time – even after the current *Turbine* plan to reduce unit costs by 8% – it is at a significant cost disadvantage to the main European LCCs (see chart).

European Airlines’ Unit Cost Curve



Source: Aviation Strategy analysis

Etihad’s *interesting* strategy

Etihad is pursuing an interesting strategy (see *Aviation Strategy* November 2013) in trying to catch up with its neighbours Emirates and Qatar in gaining global market presence to push traffic through its Abu Dhabi hub by buying stakes in moribund carriers. While spending a small fortune on airberlin it has also taken a stake in Darwin – a small Swiss regional airline – and renamed it Etihad Regional, and acquired the maximum possible stake in Air Serbia (the former JAT). It is currently also reputed to be in discussions to acquire up to 49% of Alitalia for perhaps €500m.

While officially Etihad legally cannot be seen to have majority ownership or exercise control in a European airline, it appears obvious that it is providing significant input into the possible direction that airberlin may take in its restructuring. One strange (and perhaps logistically unlikely) possibility could be that a re-engineering of airberlin may be connected in some way with Etihad's plans for a recapitalised Italian flag carrier. If it were, this may well create a significant nuisance to the three top European network carriers, in providing a fourth force after they have done so much work in consolidating the industry.

The European Commission, meanwhile, has started to investigate the level of control exercised by non-EU shareholders of EU and EEA airlines (including, to keep it fair, that of Delta in Virgin Atlantic). Lufthansa in particular will be in a quandary. It has been particularly vocal in its objection to the super-connectors' picking up traffic from behind its Frankfurt or Munich gateways, and yet up to now seems to have been fairly happy in having airberlin as a weak competitor and a shield against Ryanair or easyJet.

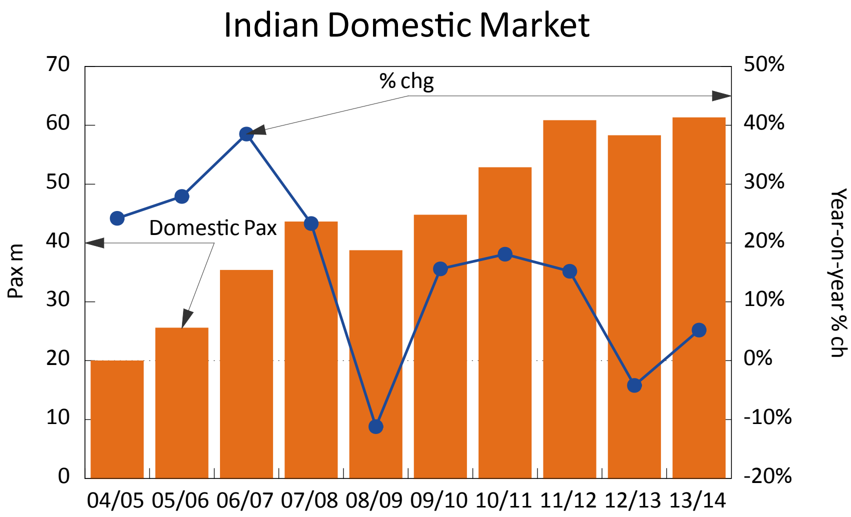
Whatever the criticisms of the level of investment by Etihad in airberlin, it has allowed it a modicum of breathing space to carry out a wide-ranging restructuring. Pointedly James Hogan dismissed concerns about the extent of airberlin's losses, saying: "If we were not convinced airberlin could be re-engineered we would not have invested". However, there may be more problems when airberlin seeks further equity injections from shareholders in the next downturn – if not before. Meanwhile, the new Chief Restructuring Officer, however permanent his position may be, is in for some interesting times.

India's LCCs struggle through tough times

INDIA's LCCs have toiled for years to survive and scrape a profit in a market with one of the highest passenger growth rates in the world. But that same growth rate and the opening up of the aviation market to foreign investment is now encouraging yet another wave of new airlines in India. Can the established Indian LCCs survive?

As can be seen in the graphs on this page, both domestic and international traffic has already risen significantly in the last decade, and according to Boeing over the next 20 years India is forecast to have one of the highest passenger traffic growth rates in the world, driven by GDP growth and higher disposable incomes, particularly among the growing urban-based middle classes, who number around 300m-400m out of a total population of 1.3bn.

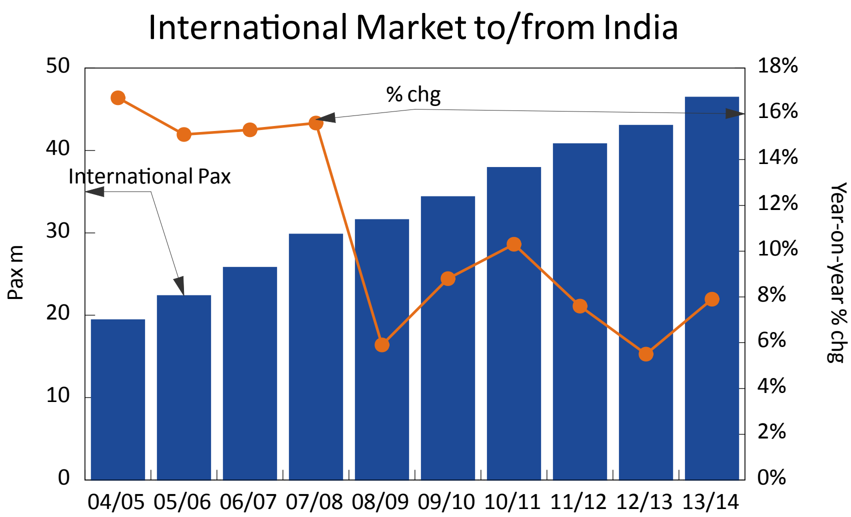
The Indian government began to liberalise significantly the aviation industry in 2004 (see *Aviation Strategy,* December 2003 and June 2007), and a number of LCCs have sprung up since then to exploit this liberalisation. However, in September 2012 the government took the major step of allowing foreign airlines to own up to 49% of local carriers, and as a result overseas carriers began hunting for opportunities to enter the Indian market. Etihad Airways moved first by paying $380m for 24% of Jet Airways in 2013, while both Singapore Airlines and AirAsia are setting up Indian operations in the near future. Add in purely Indian start-ups such as Air Costa and Air Pegasus, and the



Source: AAI Note: year end March 31

prospects for the Indian aviation industry look bright, particularly given that the Indian market is still hugely underserved, with hundreds of large towns and cities that have little or no air connection.

But while prospects for Indian aviation may well be bright as a whole, for the incumbent LCCs the impact of this new wave of competition could be fatal. Many of them have struggled to convert the growing willingness of the middle classes to travel by air into a profitable business model, because although this market is large and growing, it is still relatively "poor" by western standards of income, and as a result is very sensitive to fare prices. This high elasticity of demand has encouraged LCCs to cut fares at



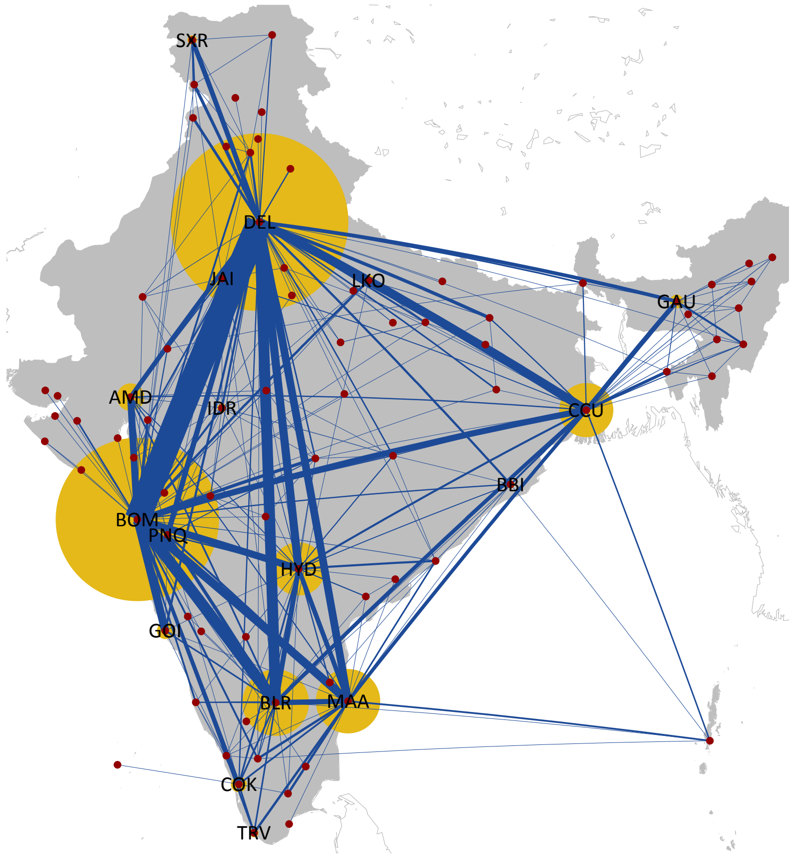
Source: AAI Note: year end March 31

every opportunity in order to boost demand, but when all airlines do it the result is a downward spiral in overall revenue and profitability. And that spiral is continuing – a latest round of air fare cuts initiated by SpiceJet in April 2014 has encouraged fares to fall to their lowest levels in around two years.

The market is also distorted by high airport charges and taxes on jet fuel – perhaps most significantly of all – by the competition provided by Air India, which continues to be supported by the Indian state after making colossal losses. To make matters worse, over the last year India's airlines have struggled to overcome the impact of the rupee's sharp depreciation against the US Dollar (by around 11% in just 12 months), which has – along with significantly higher fuel prices – helped to increase operating costs for Indian airlines by at least 20% in 2013.

In the following pages *Aviation Strategy* takes a look at each of the major Indian LCCs in turn.

India's Domestic routes



Note: The thickness of the lines represent the volume of capacity on each route. The area of the large circles relate to total domestic capacity at the top airports.

Indian LCC Fleets

Fleet (orders)	IndiGo	SpiceJet	GoAir	Air India Express	JetKonnect
A320	78 (7)		18		
A320neo	(160)		(74)		
A321neo	(20)				
737-700					5
737-800		37 (17)		17	4
737-900					2
737-900ER		6			
737MAX		(42)			
Dash 8 Q400		15 (15)			
ATR 72					5
Total	**78 (187)**	**58 (74)**	**18 (74)**	**17**	**16**

Indigo

Based at Gurgaon, IndiGo was launched in 2006 by Rahul Batia, owner of Indian conglomerate InterGlobe Enterprises, and Rakesh Gangwal, a former CEO of US Airways who now runs US-based Caelum Investments. Those two entities hold 51.1% and 48% stakes respectively in the airline.

Today IndiGo has the largest fleet of all the Indian LCCs, with its 78 A320s having an average age of less than three years. With its main base at Delhi and with secondary bases at Mumbai and Kolkata, IndiGo operates to 31 domestic and five international destinations; it started international operations in 2011 and currently operates from Mumbai and Delhi to Bangkok, Dubai, Kathmandu, Muscat and Singapore.

The airline has a hefty 187 aircraft on order (the largest order book of any Indian LCC), comprising 167 A320s and 20 A321s, the majority of which are neo models. IndiGo placed an order for 180 Airbus aircraft in 2011, worth $15bn at list prices, and 160 A320neos will start arriving from 2016 and 20 A321neos will be delivered from the following year, with all the neo being delivered by 2025.

IndiGo is likely to add substantial new orders sometime this year (for as many as 250 aircraft, one analyst believes) and it would be a shock if they were for anything other than further A320neos – although the airline has previously indicated that it may look at regional aircraft at some point in the future if market economics make sense.

IndiGo tightly follows a traditional LCC model, with single aircraft type and a single class product that has paid-for meals and no in-flight entertainment. Perhaps because of that focus it has a 30% leading share of the Indian domestic market – and unlike many of its rivals IndiGo is profitable.

Some analysts have speculated that IndiGo makes a substantial book profit by selling and leasing back its aircraft, but the airline has denied this, and it's difficult to verify either way given that as an unlisted company IndiGo releases relatively few financial details.

IndiGo has yet to post results for the financial year ending March 2014 (they are likely to be revealed around September, as is customary among almost all Indian airlines), but in the 2012/13 financial year it reported a substantial six fold rise in net profit to Rs7.9bn (US$143m), its fifth straight year of profitability. The increase was based on a 39% rise in capacity and 20% rise in average yield over the year, with revenue up 65% year-on-year to Rs95bn (S1.7bn). Operating profit for the 2012/13 financial year totalled Rs9.9bn ($181m).

Aditya Ghosh, president at IndiGo, says the secret to its profitability is a relentless pursuit of cost cutting and a focus on a basic and simple product. "We haven't tried anything fancy, or bizarrely different," he says, and the airline's reputation for reliability and consistent products allows it leeway to charge higher fares than many of its LCC competitors – and even more than full-service competitors Air India and Jet Airways on certain routes. But not too high – Rahul Bhatia, group MD of InterGlobe Enterprises, which owns IndiGo, says that as with all Indian airlines "the weak rupee and high fuel prices are putting pressure on margins", but that "the religion in IndiGo is to keep prices low, otherwise I don't think we can grow at 20-30% annually".

The longer-term plan is to keep growing by around 10-15 aircraft a year for the next decade, which appears sustainable, and a potential IPO in 2015 or 2016 is a distinct possibility. IndiGo took a long look at doing an IPO back in 2010 after hiring no less than five financial advisors, but decided to not go ahead at that point. However, prior to an IPO it's possible that the airline may attract a foreign investor; Qatar Airways is apparently interested in acquiring a stake. The two airlines know each other well – in May 2013 Qatar and IndiGo apparently held talks about a codeshare deal, though this came to nothing.

A financial tie-up would make strategic sense for both carriers. The Middle East has proved an attractive market for IndiGo – it operates more than 20 flights week between India and the Gulf regions, with its routes to Dubai and Muscat proving popular with the Indian expat and working community in the region.

Qatar may be looking to match rival Etihad's purchase of a stake in Jet Airways, though the Doha-based carrier has also been linked with an investment in SpiceJet, as well as reportedly looking for codeshares with virtually the entire Indian aviation including Go Air, IndiGo, SpiceJet and even Air India.

SpiceJet

Based at Chennai airport, SpiceJet's origins date back to early 1990s when ModiLuft was launched by entrepreneur S K Modi in partnership with Lufthansa to become one of the first full-service carriers to emerge to provide competition to Air India. ModiLuft ceased operations in 1996 but its AOC was taken over by Royal Airways. The owners of Royal, by this time a dormant airline, made the bold move of planning and setting up India's first LCC and ordering new 737-800s. The Mumbai and Delhi investor presentations not only raised the necessary capital but accidently helped launch two other rival LCCs.

In 2010 a 37.7% share of SpiceJet was acquired by Indian conglomerate the Sun Group, which is controlled by billionaire Kalanithi Maran, and this has since risen to at least 49% (with the rest on a free float).

SpiceJet's first LCC operations began in 2005 and today SpiceJet operates a fleet of 58, with an average age of 4.5 years, to around 41 domestic and seven international destinations. In December last year SpiceJet signed a three-year interline agreement with Singaporean LCC Tigerair, becoming the first Indian LCC to agree such cooperation with a foreign airline.

SpiceJet has 74 aircraft on firm order, comprising 17 737-800s, 42 737MAXs and 15 Dash 8 Q400s. The 737 MAX 8 order was announced this March (though it was reportedly agreed between Boeing and the airline last October), in a deal worth $4.4bn at list prices, and with the first aircraft due to be delivered in 2018. The MAX order has apparently taken the place of the outstanding 737-800 firm order, though for the moment the -800s still remain in the Boeing order book.

The 15 Q400s in SpiceJet's fleet connect SpiceJet's main bases to secondary and tertiary cities in India, and another 15 of the type will expand this network.

SpiceJet is the second-largest LCC in India with an approximate 20% share of the domestic market, but despite that and even with the deep pockets of its owners, SpiceJet has struggled to make a profit.

In the first three-quarters of the 2013/14 financial year (the nine months to 31st December 2013), SpiceJet saw revenue rise by 12.6% to Rs47.7bn ($772m), although the operating result turned from a profit in the first nine months of 2012/13 to a Rs5.9bn ($96m) operating loss in April to December 2013. The net result similarly plunged from a Rs5.4bn ($97m) loss to a Rs6.8bn ($110m) loss over the same comparative nine-month period.

The airline blames the weaker rupee, which inflated lease and fuel costs by around Rs630m ($10m) in the last three months of 2013. It adds that fuel prices were 9% higher in the same quarter year-on-year, with fuel costs accounting for 52% of revenue in the October-December 2013 period, compared with 45% a year previously.

Overall costs per ASK rose 10% in the quarter, which was not offset by a 3% rise in passenger yield in the same period. SpiceJet adds that "demand for air travel softened during the year, exacerbated by more seats due to planned additional aircraft by the Indian aviation industry – including SpiceJet". Load factor fell significantly in the three month period to December 2013, from 75% to 70.5%, and overall revenue per ASK fell 6% in the quarter.

SpiceJet is attempting to return to profitability through a series of measures that include cost reductions, productivity improvements and "a complete network and schedule redesign". This includes a greater emphasis on attract higher margin passengers. While an LCC, the airline has been straying into full-service enhancements. SpiceJet offers premium seats, with priority check-in and extra baggage allowance, and the airline is reconfiguring its 737 aircraft to offer five seat rows with enhanced legroom. SpiceJet also recently launched an FFP for business travellers called Corporate Frequent Flyer, where customers booking through corporate accounts gain one free flight for every six tickets booked. And this May SpiceJet also launched its biggest advertising campaign for more than three years, which reportedly will include television adverts in the coming months.

Some analysts believe that though laudable, these efforts will not succeed in make the airline profitable, and that the real problem is that SpiceJet is significantly undercapitalised, with an urgent need to attract new investors and capital. Indeed the airline is expected to post a loss of as much as Rs10bn ($162m) for the full 2013/14 financial year, which would be not far off its accumulated losses over the previous seven years.

The intentions of SpiceJet's current owners are unknown, but the carrier will reportedly get a new CEO this summer when Sanjiv Kapoor is promoted from his current position of COO (which he became in November 2013). The previous incumbent CEO was Neil Mills, who left last year to join Philippine Airlines. An American citizen, Kapoor was previously CEO of Bangladesh's GMG Airlines.

The first item in his in-tray will be whether to continue with deep fare cutting. SpiceJet initiated another round of fare wars in India earlier this year, which was inevitably copied by its competitors even though one of them called SpiceJet's move "suicidal".

GoAir

GoAir was founded in November 2005 by Jehangir Wadia, a member of the family that run the Wadia group, an Indian conglomerate that dates back to the 18th century and which today has interests in everything from chemicals to health care.

With Jehangir Wadia as CEO, the airline has grown slowly, though the company says that this has been intentional as it prioritises profitability ahead of winning market share. GoAir currently operates a fleet of 18 A320s (with less than four years' average age) to more than 20 destinations in India. It offers a partly traditional LCC model, with a single model fleet and paid-for meals, although it also offers a premium service called GoBusiness that includes meals, a spare middle seat in between passengers on selected routes (such as Mumbai-Delhi). It also offers an FFP called Go Club, which was the first FFP to be offered by an Indian LCC.

GoAir has 74 A320neos on order, of which 72 were placed in 2011 in a deal worth S5.4bn at list prices. Deliveries are due to begin in 2016, with aircraft arriving at around 15 per year after that. Until then growth will come by further leased aircraft, according to CEO Giorgio De Roni, (who has been in the position since 2011 and who was previously chief revenue officer of Italian carrier Air One) with two more aircraft being added by the end of this year and further leased aircraft in 2015.

GoAir's main operation is based at Mumbai, with a secondary base at Delhi, and flights to and from Delhi and Mumbai account for approximately half of all services, with the Mumbai-Delhi trunk route by far its most important route.

GoAir has an approximate 8% to 9% share of the Indian domestic market, and it particularly gained share after the exit of Kingfisher Airlines in 2012. In the 2012/13 financial year (ending March 31st) it made a Rs1bn ($19m) net profit, compared with a Rs1.3bn ($26m) loss in 2011/12 – although all of the profit came from the sale and leaseback of aircraft; excluding sale and leasebacks, GoAir's losses would have been Rs793m ($14m).

However, in the first six months of the 2013/14 financial year (April-September 2013) GoAir saw passengers carried rise more than 30%, to 2.6m, and the airline says it's on target to record another profit in the 2013/14 financial year.

GoAir's fleet will reach around 37 aircraft by the end of 2017 and it is keen to launch international services, although as a result of its current size GoAir is prohibited from operating these under government regulations called the 5/20 rules, whereby domestic airlines are not allowed to operate internationally unless they complete five years of domestic operations and have a minimum fleet of 20 aircraft.

The airline has lobbied unsuccessfully to overcome these restrictions, although some analysts believed they may finally be scrapped by the government this summer – which will be irrelevant to GoAir as its 20th aircraft should be delivered in July or August anyway, which will then fulfil the last of these criteria.

Either way, GoAir will start international operations by the end of this year at the latest, with at least 10% of its capacity being dedicated to international services – though this will depend on securing traffic rights into the markets it targets. These are believed to be in the Gulf region and neighbouring south-east Asia countries, with GoAir likely to prioritise international services from second tier cities – i.e. not from Mumbai and Delhi, where international competition is fierce.

Domestically, growth will also be seen primarily on routes to secondary cities, such as Patna, Lucknow, Jaipur, Kochi, Chandigarh, and Jammu and Kashmir, with De Roni saying that "metro to metro business has not witnessed a similar pace of growth˝. A number of other secondary cities will be added over the next two years, and in particular in the east of the country, which the airline believes is particular underserved.

Along with SpiceJet, GoAir is also mentioned by analysts as being potentially available for foreign investment, and the Indian press has reported that talks have been held with Lufthansa, Emirates and Qatar Airways. Last year De Roni said that: "The shareholders are not interested in selling the company, but they want a partner to support the growth of the company˝. JP Morgan has been appointed to help with the search for a "partner", and sources suggest that negotiations are advanced with at least one carrier.

Air India Express

Air India established its LCC subsidiary – Air India Express – in 2005 to operate to destinations within a four hour flying time from the country, with a typical LCC turnaround of no more than one hour at all airports.

Air India Express operates a fleet of 17 737-800s (four others were recently returned to lessors), with an average age of more than six years. The carrier is headquartered at Cochin airport in and has two other main operating bases – Calicut airport in Kozhikode and Trivandrum airport in Thiruvananthapuram. As such most of its flights operate to and from the south of the country, with 12 domestic and 13 international destinations served.

The majority of Air India Express's international focus is on routes to the Middle East – including to Dubai, Sharjah, Abu Dhabi, Al Ain, Muscat, Salalah, Bahrain, Doha and Kuwait – where the carrier serves Indian expat communities in those countries. The remaining international destinations are Singapore, Kuala Lumpur, Columbo and Dhaka.

However, under a new CEO appointed in April this year – K. Shyam Sundar – Air India Express has plans to significantly increase its international network outside of the Middle East as part of an expansion that will see the fleet rise to 36 by 2017. 19 more 737-800s will be leased over the next three years, and it has already released a tender for the dry lease of eight aircraft. However, the process of acquiring new aircraft is somewhat complicated for Air India Express as it needs to get government permission for major new expenses, which given the precarious financial position of Air India is not an easy process.

Nevertheless, potential new destinations believed to be under analysis include Iran, Russia and other CIS countries – although as yet Air India Express will not confirm those target markets. Sundar and other senior Air India Express executives believe that there is significant demand for LCC services to the Middle East and Asia that is currently going to competitors, and that an expanded Air India express network will win passengers that want to be loyal to the Indian flag carrier.

The airline offers a single class service, although free in-flight meals and entertainment are included with all fares, and passengers can now preselect seats for a fee. However, last year Air India Express reduced its free baggage allowance from 30kg to 20kg per passenger, charging for any extra weight, which was met with criticism from some passengers.

In terms of financial reporting Air India Express is part (and the only part) of Air India Charters Limited, which in turn is a subsidiary of Air India, and the last full report made available for Air India Charter is for the 2011/12 financial year ending March 31st 2012. Reported revenue for the year was Rs13.8bn ($267m), a 2.2% rise on the previous financial year, with net loss totalling Rs6bn ($116m), compared with a Rs3.9bn loss in 2010/11. The improvement in revenue was due largely to a 2.5% increase in load factor to 71.0% in 2011/12, and a 7.6% rise in yield. During the 12 month period Air India Express carried 2.31m passengers, compared with 2.38m in the previous financial year.

Air India Express now operates independently of its parent airline and is building up its own pilot workforce. Despite having its own AOC in previous years the LCC has faced problems as it used Air India pilots for all its flights, and they were inevitably prioritised to Air India flights, with Air India Express getting pilot hours only when it suited their parent's schedules. This even led to flights being withdrawn, and two years ago the airline told the Indian aviation ministry that it needed at least 200 more pilots in order to operate effectively.

That shortfall has now been made up, with direct hires to the company and the building up of its own pilot training resources. The extra pilots have also helped increase aircraft utilisation, which according to one report was as low as six hours a day in 2012, well below standard.

JetConnect

JetConnect (or JetKonnect as variously spelled by the company) is an LCC based in Delhi that has a somewhat complicated history. The carrier was previously known as Jet Airways Konnect and prior to that (until 2012) it was called Jetlite. That airline previously operated as Air Sahara, an Indian carrier that began life under the name Sahara Airlines back in 1993. Sahara was a strong brand in India in its rôle as a micorlender. Sahara Airlines became Air Sahara in 2000, and in 2007 it was bought by Jet Airways for $340m, after which it was immediately renamed as Jetlite. Finally, in March 2012 Jetlite was submerged into Jet Airways low cost brand JetConnect (which had launched in 2009), then becoming a separate airline under that name.

Parent company Jet Airways was founded (and is still chaired) back in 1993 by Naresh Goyal, one of the richest men in India, and today it operates 114 aircraft domestically and internationally. However it has been loss making for a considerable number of years, although white knight Etihad Airways bought a 24% stake in Jet Airways for around $380m last year (see *Aviation Strategy,* November 2013).

Most immediately the Gulf carrier's injection of investment and resources at least makes JetConnect's parent a more stable entity, but the deal also opens up the question of just how Etihad sees JetConnect fitting into an overall strategy for Jet Airways.

Although flights and schedules at JetConnect have been altered in order to connect better with Jet Airways and Etihad flights, there were reports last year that in anticipation of the Etihad deal Jet Airways may want to convert JetConnect into a full service airline, in order to bring it closer to the Jet Airways product and to avoid so-called "brand confusion" with its parent. That hasn't happened so far, although just how much JetConnect is an actual LCC is open to debate.

Today the airline operates an assorted mix of 16 aircraft – comprising five 737-700s, four 737-800s, two 737-900s and five ATR 72s – on a solely domestic route network linking 55 destinations. As well as a varied fleet it has other "non-LCC" attributes, such as two classes on selected services, with a Première class offering in-flight meals, improved seat pitch, dedicated check-in counters and lounge access, as well as an FFP called JetPrivilege (effectively exactly the same as Jet Airways' FFP).

JetConnect has an estimated 6-7% market share of the Indian domestic market, which it maintains through constant fare wars with its rivals – in January this year it slashed fares by 50% via a 30-day advance purchase fares on certain routes (a discount that ran until April).

JetConnect's results are not separated out from its parent, though in the first three-quarters of the 2013/14 financial year (the nine months ending December 31st 2013) Jet Airways reported a net loss of Rs15bn ($245m), with domestic operations (including both Jet Airways and JetConnect) accounting for Rs52bn ($849m), though this was down 3.9% compared with the April to December period of 2012.

Gol's rationalisation and revenue management efforts pay off

Amid Brazil's prolonged economic slowdown, currency woes and World Cup challenges, Gol, Latin America's leading LCC, has staged a surprisingly robust financial turnaround. But because the airline has had to dig itself out of a very deep hole, its operating margins are still in the low-to-mid single digits – a significant improvement from the negative 11.2% margin seen in 2012 but nowhere near satisfactory.

Gol's problem is that there is no let-up from external challenges. Brazil is in its fourth consecutive year of modest GDP growth, with more of the same expected in 2015. The latest projection is for only 1.6% growth in 2014, followed by 2% in 2015 (a mid-May survey of some 100 financial institutions in Brazil). Inflation is on the rise, currently projected to be 6.4% in 2014.

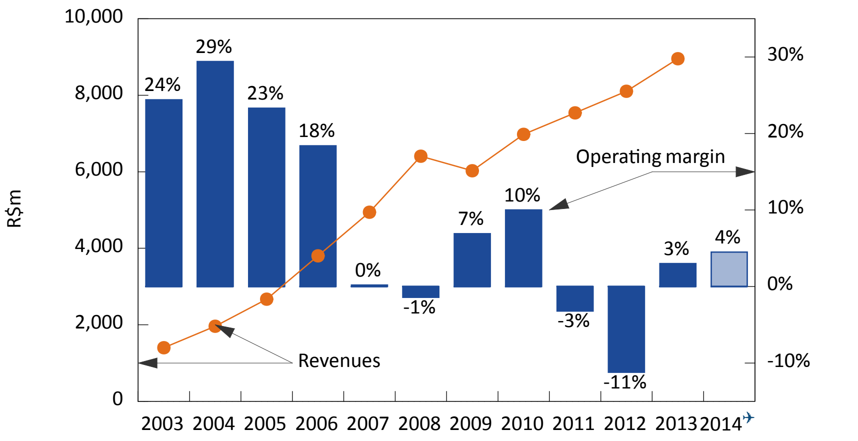
In the past year the Brazilian Real has hovered in the 2.2-2.5 to the dollar range – a low level not seen since 2008. More weakening and volatility are on the cards for the second half of 2014, given likely changes to the US interest rate policy and Brazil's general election in October. The Real at that level is keeping Gol's fuel prices at record levels.

Gol, like its Brazilian peers, faces a challenging June-July period catering for a spike in low-yield demand because of the World Cup. It will be a financial negative for the airlines in the short term, because business travel is expected to be down sharply during the Cup.

And competitors are making bold moves. Azul, Brazil's third largest carrier, recently announced plans to enter the Brazil-US market in early 2015, initially with six A330-200s and later with A350-900s. The planned daily nonstop, low-fare flights from Azul's São Paulo Campinas hub (from where it serves 104 domestic destinations) to various US gateways could potentially undermine Gol's strategy of operating one-stop flights to the US.

Gol's main competitor TAM is now much stronger because it is part of the Latam Group. With Latam's help and expertise, TAM has turned around its Brazil domestic operations, which are now profitable. Also, Latam has almost eliminated TAM's balance sheet exposure to the Brazilian Real (see *Aviation Strategy*, April 2014).

Gol's Revenues and Operating Margins



Note: ✈ Mid-point of the 3-6% forecast Gol reaffirmed on May 15.

Revenue-led turnaround

According to its Q1 presentation, Gol achieved the highest EBIT margin improvement among 15 international carriers in the 12 months ended March 31. Its margin rose by 13.4 percentage points, compared to runner-up IAG's 10.6, Alaska's 6.4 and Delta's 4.5 point improvements.

The key reason was Gol's outstanding unit revenue performance. Its RASK rose by 17.7%, compared to the 4% increase seen by the next-best carrier (Alaska). Gol has also seen strong yield and load factor improvements; in the first quarter, its load factor rose by nine points to 76.1%.

The dramatic RASK and load factor shifts were possible because Gol contracted in size and because capacity and pricing discipline has prevailed in the Brazilian airline industry since early/mid 2012 – at least at Gol and TAM, which still account for 75% of the domestic market.

Gol is now 14% smaller in terms of ASKs than two years ago (March quarter figures). It is unusual for an LCC to shrink like that, though Gol had boosted its size through two acquisitions – Varig in 2007 and Webjet in 2011. The Webjet integration definitely helped the latest restructuring efforts in 2012 and early 2013, because Gol opted to end Webjet's operations and dispose of its 20 737-300s.

Better yield management and a new focus on more profitable routes have also contributed to Gol's strong RASK trends. In early 2013 Gol implemented what it described as a "new route network", which involved eliminating some routes, reducing night flights, strengthening São Paulo Guarulhos hub operations, improving connectivity with partners and increased focus on the corporate market.

Of course, the main benefit of the R$70m Webjet acquisition was that it strengthened Gol's slot holdings at six key airports: Guarulhos, Brasilia, Galeao, Santos Dumont, Confins and Porto Alegre's Salgado Filho.

Despite its sharp contraction (and because TAM also contracted), Gol actually improved its domestic market share (in RPKs) by 1.8 points in the past year, to 36.6% in Q1 2014. In that period TAM's share fell by 3.1 points to 38.1%, Azul's remained unchanged at 16.7% and Avianca Brazil's increased by 1.2 points to 7.9%.

Gol's revenue performance may also have benefited from the move more upmarket with JetBlue-style products like "GOL+Conforto", which was first introduced on the 737-800s on the Rio-São Paulo shuttle late last year. The product features more comfortable seats, with extra legroom and more space between seats, in the first seven rows of the aircraft. The seats are offered free of charge to elite FFP members and sold from R$30 to other customers. Like JetBlue, Gol has found the strategy so successful that it is now expanding it to its entire domestic fleet, including 737-700s. By the end of May, 80% of Gol's fleet will have those seats.

Gol can soon advertise that it offers the "largest number of category A seats" (an ANAC classification) in Brazil. There are efficiency benefits associated with having only one type of configuration for each aircraft model. And the move makes it easier to keep capacity in check this year.

So Gol has done a lot of work on the revenue side. Notably, a new leadership took over in June 2012, when Paulo Kakinoff, formerly Audi's Brazil head and a Gol director, replaced founder Constantino de Oliveira Jr. as CEO.

Terrible cost headwinds

The 2012 restructuring included some promising cost cuts (notably from a 20% headcount reduction), which enabled Gol to keep its total unit costs flat in 2013, despite the ASK reduction. But recent months have seen terrible cost headwinds, as was illustrated by the 17% and 22% surges in Gol's CASK and ex-fuel CASK in the March quarter.

The main culprit has been the Brazilian Real's decline against the dollar (18% year-on-year in Q1). Because of that, Gol paid record fuel prices. Leasing costs per ASK surged by 36%, mainly because more aircraft were on operating leases but also because of the weaker currency. There were inflationary pressures in many cost categories, including labour.

In the non-operating categories, Gol incurred sharply higher interest expenses because of the Real's decline. Gol had to pay income tax because of profits earned at its FFP unit Smiles. There were odd items such as a R$56m "interest hedge" expense. And Gol conservatively recognised a R$76m ($34m) loss from the devaluation of the Venezuelan bolivar against the dollar. (Gol had R$351m cash trapped in Venezuela at the end of March and will of course continue to fight to get the funds repatriated at the original exchange rates.)

Because of the cost headwinds, Gol achieved only a 3.9% adjusted operating margin in Q1. The reported operating profit of R$144m (5.8% of revenues) included a R$48m gain from a sale-leaseback transaction. The net loss for the quarter was R$96m.

Although Gol achieved a R$266m ($120m) operating profit in 2013, it has had net losses for three consecutive years, losing R$3bn ($1.4bn) in aggregate in 2011-2013.

A lot to Smile about

Smiles, the FFP that Gol listed publicly in April 2013 but still includes in its consolidated results (54.5% owned), has truly been a bright spot financially. In addition to helping Gol attract and retain passengers, Smiles is highly profitable. It earned net profits of R$208m and R$78m ($94m and $35m) in 2013 and Q1 2014, respectively, representing 36% and 42% of revenues.

The IPO raised R$1.1bn ($495m). In April Smiles' board approved a R$1bn ($450m) "capital reduction" or a special dividend, which will be in addition to R$160.3m ($72m) of dividends paid for 2013. It will essentially mean a big chunk of cash redistributed to Gol from the Smiles/consolidated balance sheet and a modest increase in consolidated debt because Smiles is taking a R$700m ($315m) loan from a financial institution.

Smiles had 9.9m members and 218 commercial partners at the end of March. The membership grew by 10% in 2013 and by 7.4% in Q1 2014.

Airline partnerships

Gol is benefiting significantly from airline partnerships, especially since it has secured equity investments from two major global carriers – Delta and Air France-KLM. Gol was able to forge two such "exclusive" long-term strategic partnerships, because it had something really special to offer: long-term access to the huge Brazilian market.

Delta paid $100m for a 3% stake in Gol, a board seat, an exclusive codeshare agreement in the Brazil-US market and two 767s in December 2011. Codeshare cooperation now gives the airlines access to some 400 destinations in over 62 countries.

The February 2014 deal with Air France-KLM was modelled after the Delta agreement. It is exclusive in the Brazil-Europe market and will mean a joint reach of 318 destinations in 115 countries. The deal was also valued at $100m and includes a board seat, but there were some interesting differences. First, it comprised of two main parts: a $52m investment in Gol's preferred shares (1.5% ownership stake) and $48m "for purposes of enhancing the effectiveness of the strategic commercial partnership". Gol has not disclosed exactly what the $48m relates to, other than that $23m is for "commercial and synergies" and $15m is "due over two years as cash flow from the agreement".

Second, AF-KLM paid a steep premium for the 1.5% stake (170% above the stock's closing price that day). AF-KLM, which continues to report losses and is trying to restructure, evidently very badly wanted that foothold in Brazil. The deal gained timely regulatory approval from Brazil's CADE in early May, enabling AF-KLM to take advantage of the World Cup-related demand surge (as well as obviously next year's Olympics). AF began a new route to Brasilia in March and also plans Paris-São Paulo A380 flights.

The fact that Delta and AF-KLM are both members of SkyTeam may make it easier for Gol to coordinate its systems with AF-KLM, but Gol will not join SkyTeam. It remains committed to the "open architecture" type alliance strategy similar to those of JetBlue and WestJet.

Gol also has codeshare agreements in place with Iberia, Alitalia, Qatar, Aerolineas Argentinas and TAP. The TAP deal, announced on April 11, is interesting because TAP is the Europe-Brazil market leader, operating 74 weekly flights from Portugal to as many as 10 cities in Brazil.

International expansion

In early 2013 Gol announced a new international expansion drive that would serve two purposes: diversify revenue sources (given the sluggish demand in Brazil) and give it a natural exchange rate hedge (through an increase foreign currency denominated revenues).

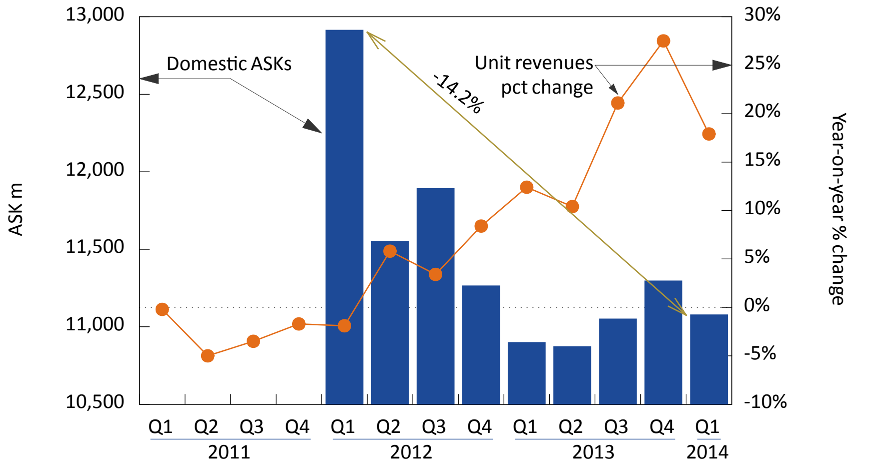
Gol had just entered the Brazil-US market (December 2012) with daily São Paulo-Orlando and Rio-Miami flights, which are operated via Santo Domingo (Dominican Republic) because the 737-800s need a fuel stop. The flights are timed to arrive in Santo Domingo at about the same time, allowing passengers to switch.

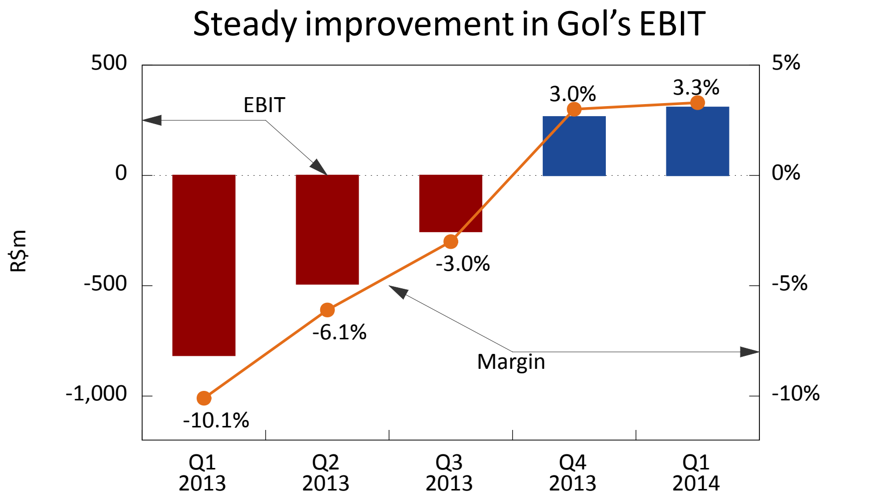
In the Q1 call Gol's management described the US services as "very, very successful". The flights have enjoyed strong demand and are very important for Smiles. Gol will be adding São Paulo (Campinas)-Santo Domingo-Miami flights in July.

But what about the potential impact of Azul's plans to operate nonstop to the US with larger, longer-range aircraft? In response to questions, Gol executives indicated in mid-May that the airline had not yet decided whether to grow the Santo Domingo operations, though there was "clear potential". (The original plans envisaged SD as a potential hub for the carrier.)

Of course, the US is just one of 15 international markets for Gol. The airline is adding new routes to Chile and Argentina this summer (Guarulhos-Santiago and Fortaleza-Buenos Aires) and expects to announce more international expansion before the year-end. Gol is on track with the strategy to grow its international revenues from 8% to 17% of total revenues within three years; the current level is 12%.

GOL'S Unit revenues and domestic capacity trends





Source:Gol. LTM = Latest twelve months

Balance sheet considerations

Gol does not have any liquidity issues, because it has made it a policy to maintain strong cash reserves ever since it narrowly escaped a cash crunch after the Varig acquisition. Total cash at the end of March was R$2.8bn – a very healthy 30% of annual revenues.

Gol remains highly leveraged, though, with total debt of R$5.5bn ($2.5bn) and adjusted debt (including leases) of R$10.8bn ($4.9bn) as of March 31. But growth in EBITDAR has greatly improved debt ratios, and there are no major repayments due this year. Gol remains committed to reducing short-term obligations and keeping a strong cash position.

Even though Gol postponed many deliveries when it began cutting capacity, its aircraft capex remains sizable, at R$1.1-1.2bn ($495-540m) annually in 2015-2016. But the new aircraft will be for replacement, and the year-end 2015 and 2016 operational fleets will actually be smaller than what Gol had three years ago (though total seats will increase because Gol is receiving 737-800s and retiring 737-700s). The March 31 operational fleet comprised of 141 737-NGs (not including six aircraft that were being returned to lessors) and is expected to remain at 140 in 2015 and 2016. The total firm orderbook with Boeing is impressive: 133 aircraft, valued at R$34.1bn ($15.3bn).

Gol aims to be free cash flow (FCF) neutral this year but hopes that from 2015 better margins and continued capital discipline would lead to positive FCF. As long as EBITDAR margins remain high (17-18% in recent quarters), there will be no cash constraints or pressure to reduce capex.

Outlook

The steady improvement trend in Gol's operating profit in the past five quarters (see chart) offers much hope for the future. Even in this very difficult external environment, Gol has been able to improve its operating margins.

Gol is projecting a 3-6% operating margin for 2014. The forecast is based on realistic assumptions: Brazilian GDP expanding by 1.5-2%, the Real weakening further to R$/US$ 2.40-2.50 and fuel prices increasing from the Q1 level. Gol expects its domestic ASKs to decline by 1-3%, international ASKs to increase by 8%, RASK growth to exceed 10% and ex-fuel CASK to increase by 10% or less in 2014.

Although the forecast has some level of negative financial impact from the World Cup built in, that is one area of uncertainty. It is hard to predict how much business travel demand will decline in June-July and much will also depend on Gol's pricing strategy.

Preparing for the World Cup has been one big hassle for Brazil's airlines. They have been subjected to increased ANAC monitoring and are under the threat of penalties for delays, overpricing, "misuse of slots" and such-like during the Cup. And, of course, each airline wants to "put its best foot forward" for the throngs of foreign visitors that will be flying domestically in Brazil.

Gol has provided 974 extra flights or flight-time changes for the Cup. It has invested in a "new visual identity" at the 12 host airports and on its website and mobile platforms, which included adding three new languages. It has provided special training to employees, hired additional staff and reallocated personnel. Four of its aircraft have received special paint jobs.

Analysts say that if the financial impact of the Cup is not too bad, Gol could report a positive EBIT margin for the June quarter for the first time since 2010. But, because exchange rates are not cooperating, a net loss is expected for a fourth consecutive year. Of course, the long-term prospects for Brazil and Gol remain excellent.

By Heini Nuutinen
hnuutinen@nyct.net

Subscription Form

Enter my Aviation Strategy subscription for: 1 year (10 issues - Jan/Feb and Jul/Aug are combined)

- UK: £450 + VAT @20%
- EU: €550 + VAT @20% (unless valid VAT number supplied)
- USA and Rest of world: US$750

starting with the ______________ issue

- ❑ I enclose a Sterling or Euro cheque made payable to Aviation Strategy Ltd
- ❑ Please invoice me
- ❑ Please charge my Visa/Mastercard credit card £450+VAT (if required by law)

Card number ______________________ Expiry________

Name on Card ______________________ CV2 ________

- ❑ I am sending a direct bank transfer of the the relevant sum net of all charges to Aviation Strategy's bank account:

Metro Bank Ltd, 1 Southampton Row, London WC1B 5HA
IBAN: GB04 MYMB 2305 8013 1203 74
Sort code: 23-05-80 Account no: 13120374
Swift: MYMBGB2L

Delivery Address

Name ______________________
Position ______________________
Company ______________________
e-mail ______________________
Telephone ______________________
VAT No ______________________

Invoice Address

Name ______________________
Position ______________________
Company ______________________
Address ______________________
____
____
Country ______________________
Postcode ______________________

DATA PROTECTION ACT

The information you provide wil be held on our database and may be used to keep you informed of ourpproducts and services or for selected third party mailings

PLEASE RETURN THIS FORM TO:

Aviation Strategy Ltd, Davina House, 137-145 Goswell Road
London EC1V 7ET, UK
e-mail:info@aviationstrategy.aero
Tel: +44(0)207-490-4453, Fax: +44(0)207-504-8298
VAT Registration No: GB 162 7100 38